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Open regionalism *and economic* integration

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Economic integration in Latin America has entered upon a new stage, conditioned by new development strategies undertaken mostly by democratically elected governments, and directed at adjusting to a changed and increasingly demanding world economy, while attempting simultaneously to increase the Latin American countries' competitiveness. In the first section of this paper, the "stylized facts" of this new stage of economic integration are briefly reviewed, after which an explanation is given, in section II, of the main determinants of the significant growth of reciprocal trade and investment flows within the region that has taken place in the 1990s. Section III then explores the meaning of "Open Regionalism", a proposal put forward by ECLAC regarding economic integration in the region in the present circumstances. In the final section of the article, some of the obstacles likely to be faced by economic integration in the future are identified.

I

The stylized facts of economic integration in Latin America

There are two phenomena which characterize the process of economic integration in the 1990s: first, the proliferation of free trade agreements, especially at the bilateral level; second, the significant expansion of reciprocal trade and investment within the region.

1. Characteristics of recent integration agreements

With regard to the first aspect, at least ten bilateral free trade agreements have been signed between 1990 and 1993, in addition to 14 more that were signed between 1982 and 1990 (ECLAC, 1994, table II-5). Of these, Chile has been a partner in four and Argentina in three. Additionally, MERCOSUR (the Common Market of the South)– an integration agreement which includes Argentina, Brazil, Paraguay and Uruguay– was formed in 1991. [1] All these agreements share five characteristics.

First, the coverage of the new agreements of the 1990s in terms of liberalization, though still limited, tends to be greater than in the past. Specifically, only four out of the ten new bilateral treaties concluded between 1990 and 1993 have "negative" lists of products excluded from free trade, whereas the remaining six have more restrictive "positive" lists referring to the products which benefit from free trade. Nevertheless, this compares favourably to the recent past, since only one out of 14 bilateral free trade agreements signed during the 1980s had a negative list. Moreover, MERCOSUR includes a commitment to gradually eliminate all exceptions included in its negative lists.

Second, more recent agreements involve greater preferential tariff reductions than in the past. Whereas in the past tariff reductions were often of a partial nature, current preferences normally involve the complete elimination of tariffs.

Third, restrictive sectoral agreements are no longer very prominent, with the notable exception of automobiles. This involves a significant departure compared to the older integration agreements such as the Central American Common Market and especially the Andean Group, which included industrial programming efforts at a subregional level. There is, however, a danger that different national or regional content requirements (rules of origin) may become an increasingly important source of sectoral selectivity, through the establishment of conditions which in fact limit the expansion of trade.

Fourth, services are not usually covered by these agreements, with the partial exception of maritime and air transport. Most agreements still involve "shallow" rather than "deep" integration, that is, they refer almost exclusively to trade in goods. However, there is a growing number of agreements which include clauses on reciprocal investment, granting most favoured nation or national treatment to investment originating in partner countries. Since trade in services often involves foreign investment, these clauses in fact favour reciprocal trade in services.

Finally, the building or renewal of common institutions has not, in general, been part of this new wave of integration. Even though there has been a proliferation of agreements –including some ambitious ones like MERCOSUR–, a common trait has been the reluctance of governments to create new permanent supranational institutions in charge of promoting or monitoring integration agreements. This would appear to be due to greater informal contact between various actors (government officials, political parties, NGOs and enterprises) at a regional level, as well as greater realism concerning the role of institutions. More specifically, the greater skepticism concerning regional institutions would appear to reflect certain

□ This article is based on a presentation made at the conference "Latin America and the international economic system in the 1990s: macroeconomic adjustments and their alternatives", McGill University, Montreal, Canada, April 1994.

[1] More general integration commitments, including the association of groups of countries (Central America and Mexico, CARICOM and Venezuela, as well as the Group of Three formed by Colombia, Mexico and Venezuela) have also been signed.

frustration with regional institutions in the past, as well as the need to avoid premature institutionalization of a process of integration which is still in a state of flux.

2. The expansion of intraregional trade and investment

Together with the increase in the number of integration agreements, there has been a significant expansion of intraregional trade and investment. Intraregional exports as a proportion of total exports grew from approximately 11% in 1990 to about 17% in 1992 in the case of most of Latin America (i.e. the member countries of the Latin American Integration Association (ALADI). This proportion increased from 14% to 20% in Central America, and it remained constant only in the Caribbean. Most intraregional exports consist of industrial products, but agricultural products traded within the region also increased significantly between 1985 and 1991/92, as a proportion of total agricultural exports (ECLAC, 1994, table II-2).

Although information on intraregional investment is hard to come by, there is some evidence that it has increased significantly, shifting from the short-term capital flows of the past to more permanent direct investment at present, and including a growing proportion of regional foreign investment in services (ECLAC, 1994). There are also indications of a gradual process of rationalization of activities of subsidiaries of transnational enterprises, as they gradually adopt subregional or regional goals and perspectives instead of their older national approach that resulted from producing for relatively closed national markets in which an import substitution strategy had made itself felt.

II

The reasons for greater economic interdependence

The contribution of integration agreements, particularly of bilateral ones, to the expansion of intraregional trade and investment is not very clear. First, most bilateral agreements continue to be based on positive lists, in which reciprocal free trade is granted to only a limited number of products, thereby limiting the coverage of products subject to liberalized trade. Second, many pairs of countries without bilateral free trade agreements have experienced very high growth rates of bilateral trade: higher than between other countries which had integration agreements. For instance, in 1992 Brazil and Colombia, Brazil and Mexico, and Mexico and Venezuela experienced higher growth rates of reciprocal trade than many other pairs of countries which had signed bilateral or subregional integration agreements (ECLAC 1994).

A closer evaluation of trade patterns in the region leads to the identification of other, possibly complementary, explanations of the significant expansion of intraregional trade. First, the region's total imports have grown dramatically, increasing from less than US$100 billion in 1990 to almost US$150 billion in 1993. Second, this significant increase in imports can be attributed to lower levels of protection, stabilized economies which are experiencing signs of reactivation and, in an increasing number of cases, appreciating exchange rates. Intraregional trade has grown as part of this phenomenon. Significantly, intraregional imports as a proportion of total imports have not increased when taking the countries as a whole: they accounted for approximately 16% of ALADI members' total imports in 1990 but only about 14% four years later, in 1993.

Specifically, the growth of intraregional trade can be associated with more or less simultaneous unilateral liberalization processes. This has also allowed geographical proximity to become an important determinant of trade flows. Thus, neighbouring countries which have proceeded with unilateral liberalization, sometimes reinforced by integration agreements, have become major poles of dynamic intraregional trade expansion. These poles include Argentina and Chile, Brazil and Argentina, Colombia and Venezuela and El Salvador and Guatemala.

Furthermore, in addition to privatization, especially in the telecommunications and transport sectors (Devlin, 1993), most countries in the region have gradually reduced the number of sectors reserved for the State and for national investors, and adopted rules that do not discriminate against foreign investors (Calderón, 1993). And just as unilateral liberalization has contributed to intraregional trade expansion, deregulation and privatization has contributed to greater intraregional flows of investment, especially in services, where not only geographical proximity but also cultural affinity are important explanatory variables of these flows (United Nations, 1993). In addition to these factors, the process of economic restructuring in Latin America and the growing globalization of some of the most successful firms in the region has meant that they have begun to invest abroad, both in Latin America and beyond (Peres, 1993).

III

Towards open regionalism

Two phenomena would therefore appear to be promoting integration in Latin America. On the one hand, unilateral liberalization, deregulation and stabilization have created conditions which "naturally" or spontaneously favour greater economic interdependence between countries which share a geographical space and certain cultural characteristics. On the other hand, there are additional policies, of a preferential nature, which can further strengthen interdependence. Open Regionalism consists in strengthening the links between both elements, that is, between de-facto integration and policy-driven integration, in such a way as to enhance the competitiveness of the countries of the region and, in so far as possible, constitute a building block for a more open and transparent international economy (ECLAC, 1994).

For integration agreements to be consistent with Open Regionalism, they should meet the following requirements (ECLAC, 1994):

i) Provide for the extensive liberalization of markets in terms of sectors, including both goods and services, though without excluding different transition periods to allow for gradual adjustment;

ii) Involve broad liberalization of markets in terms of countries, which means that the entry of new members should be facilitated, especially in the case of important ("natural") trading partners;

iii) Be governed by stable, transparent rules, favouring those trade rules which are GATT-consistent and harmonizing standards in accordance with international agreements;

iv) Be adopted between countries which have managed to stabilize their economies, while strengthening regional institutions that provide balance of payments financing in order to minimize possibilities of macroeconomic disequilibria;

v) Apply moderate levels of protection against third-party competitors and favour the use of common external tariffs, phased in gradually if necessary;

vi) Eliminate or harmonize institutional arrangements (regulations, norms), facilitate the convertibility of currencies or adequate payments arrangements, and build infrastructure, all in such a way as to minimize transaction costs both within and between countries;

vii) Adopt flexible and open sectoral agreements which will favour the international transfer of technology;

viii) Include special measures to favour the adjustment of the relatively less developed countries or regions, including the *gradual* reduction of protection while granting fiscal incentives to favour intraregional investment;

ix) Favour flexible institutional arrangements, promoting widespread participation of the countries' different social sectors.

The justification for the first five conditions is quite orthodox. The first two conditions will facilitate the achievement of economies of scale and specialization and, together with stable multilateral rules (iii) and stabilized economies (iv), would help to create favourable expectations for investment, both national and foreign. Multilateral rules and harmonized standards (iii) will also reduce administrative costs and waste. The rationale for having wide membership is equivalent to that favouring "natural" partners (i.e., partners with a high proportion of reciprocal trade): namely, reducing the probability of having to purchase imports from more costly producers, while facilitating imports offered by least-cost producers: an outcome that will also be aided by low levels of protection against third party competitors (v). Larger markets will also promote greater investment. Common external tariffs (v) will discourage triangulation and contraband, and will avoid the need for strict rules of origin, which are increasingly being used as disguised instruments of protection.

The justification of the following conditions may be less well known or more controversial. The reduction of transaction costs (vi) may eliminate trade diversion resulting from preferences completely, since it can reduce the price of regionally produced goods and services below those of imports obtained from outside the region (Reynolds, Thoumi and Wettmann, 1993). Meeting this condition may need sizeable investments or substantial institutional reforms, requiring careful cost-benefit evaluations. Flexible sectoral agreements favouring the transfer of technology (vii) are part of a new division of labour with high information requirements, in which there is a growing de-verticalization of larger firms, geographical decentralization and subcontracting of productive activities, with an ongoing need for innovation and the diffusion of technology. These are also part of what can be considered as an innovation-led process of integration.

Allowing for gradual adjustment processes (viii) is based on the presumption that markets do not respond immediately to changing relative prices, especially in the case of imperfect and incomplete markets, both of factors and of final goods and services, above all in underdeveloped countries. Subsidies to favour intraregional investment in the less developed countries (viii) assume that those countries which gain most can compensate those which gain less or experience losses, and that the success of integration agreements can be undermined by member countries which do not benefit significantly from the integration process. Flexible institutional arrangements (ix) presume a process of integration which is still relatively "shallow" and in a state of flux, while greater participation of the different social sectors is a proposal which is in accordance with the democratic spirit prevailing in the region.

IV

Obstacles to furthering integration

Renewed interest in integration has been partly motivated by the recent wave of democratically elected governments in the region. The Rio Group, which is a forum for dialogue and coordination that includes South American countries and Mexico, was created in this context. Integration, correct-

1. The dangers of "closed bilateralism"

The proliferation of bilateral agreements may entail different costs. These range from administering a network of agreements, or the wear and tear that governments undergo in the process of repeated negotia-